

# **The Complete Guide To Buying A Business**

**by Richard W. Snowden**  
(Abstract of the book)

## **Selecting Your Business**

It's important to choose a business that's right for you, a decision you'll make based on your skills and personality. Anything less than a good fit will turn your dream into a nightmare quickly. Take time to do some soul searching before you begin to prospect for a business.

## **The "No" List**

To start, go back over your work history and remember the unpleasant parts and the tasks you didn't do well. Did you have trouble supervising people? Trouble with numbers? Hated the commute? Long hours? Make up a "no" list that contains the things you don't want to do in your new business. Your honest answers will help you decide what kind of business fits. If you weren't good at direct sales, for example, you'll avoid retailing.

## **Your Favorite Things**

Now think about what you enjoy doing. First, imagine your dream job. There's nothing standing in your way. What would it be? Think in terms of activities, not responsibilities. Wait a week, then create a second, different perfect job. Then wait yet another week and describe a third perfect job. Now compare them. You should see patterns of activities that you like and dislike. Isolate the things that make you happy. What you discover in this exercise, together with your "no" list, will help you evaluate specific business opportunities.

## **Critical Business Skills**

It's important to know the skills that drive a business—and whether you have them. First write down your business skills. Do you have experience in areas like supervision, personnel, data processing, or collections? What about skills in bookkeeping, forecasting, pricing, or tax law? Marketing analysis, sales management, negotiating, advertising, or prospecting? Write down every skill you can think of.

With these skills in mind, you'll look at a prospective business and ask, "What does the owner need to know and do? What must the employees do? How does the owner keep the company profitable?" Do you have the right stuff for that business? If not, keep looking.

## **Your Options**

You can strike out on your own many ways. Among them:

**Create a Start-up.** Think of the advantages—no outdated processes, no toxic dumps by the warehouse, no problem employees. On the other hand, the risk is high, you'll have no cash flow, and you'll work yourself to the bone to create a base of customers.

**Franchise.** Buying a franchise could be smart. You've got instant name recognition, business from day one, a low failure rate, and guidelines and advice to deal with the problems you'll face. Those with little experience may find a franchise the best option, but first study the franchiser well.

**Buy an existing business.** Buying an established, profitable company is the best way to build wealth. And you'll operate on your own with no interference. Though there are risks, this summary will help you avoid them.

## **What Can You Afford?**

Before you figure out how much you can invest in a business, be aware that most small businesses don't sell for all cash. The rule of thumb is that you'll pay a third in cash and the rest over three to seven years to the owner.

The cash flow of the business must be able to service the debt. If it can't, it's not a high-profit business. If you still want it, you'll have to increase the down payment or extend the number of years the note runs. By completing this form, you'll know how much you can invest (Liquid Assets Available). And by multiplying this number by three, you'll know the approximate size of the business you can afford. The seller will also want to see this form to know that you're a qualified buyer.

<b>Income</b>	
Salary	
Spouse's salary	
Dividends/interest	
Other income	
<b>Total Income</b>	
<b>Liabilities</b>	
Real estate mtg/notes	
Other long term debt	
Short term debt	
Other liabilities	
<b>Total Liabilities</b>	
<b>Assets</b>	
Cash	
Securities, stocks, bonds	
Real estate	
Household furnishings	
Automobiles	
Retirement Plans, profit sharing	
Cash value of life insurance	
Loans/notes receivable	
Value of business owned	
Other assets	
<b>Total Assets</b>	
<b>Net Worth</b> (assets - liabilities)	
<b>Total Liquid Assets Available</b> (assets convertible into cash)	

### The "Entrepreneurial Character"

Many people who start or build small businesses don't have the classic entrepreneurial profile. Yet successful small business owners share certain characteristics. They:

- Are self starters.
- Work harder than most
- Want to win.
- Have a nose for numbers.
- Prefer to lead rather than follow.
- Want to prove something to themselves.
- Seldom get sick.
- Value opportunity more than security.
- Have family support.
- Are self-disciplined.
- Have "street smarts."
- Bounce back from defeat.

You don't need all these characteristics to succeed, nor all of them in high intensity. But it helps.

### Your Accountant and Attorney

A good accountant is essential to the health of your company. It's also important to have one along to help you evaluate a potential buy. To find an accountant, ask around. Whom do business owners talk about enthusiastically?

After getting names, see where the bulk of the accountant's business falls. Is it in retailing, manufacturing, service, or non-profit work? You want experience in your area. Then get references.

When it's time to analyze an acquisition, expect the accountant to help you analyze what the business is worth, what kind of shape it's in, how you'll meet operating costs and debt servicing, what kind of money you can expect to make, and ways you can structure the deal.

## **You Need a Lawyer**

Despite how you feel about lawyers, you've got to engage one with experience in business acquisitions. A lawyer can gather information that will help you devise a negotiating strategy, and he or she can uncover problems in the deal early. For example, many businesses are in violation of zoning laws or the building code, and some may have hidden problems like toxic waste. You may become liable for such things when you buy a business, so a good lawyer can save your neck by spotting them early.

A lawyer can also draft the purchase-and-sale agreement, form a new corporation, obtain permits, negotiate the deal, and more.

## **About Fees . . .**

Good lawyers and accountants don't come cheap, but that doesn't mean you should close your eyes and hope for the best. Be specific with both about the fee structure. Find out whether your accountant will bill you a flat fee or at an hourly rate. And discuss with the lawyer exactly what is to be done. Get an estimate of the total cost, and ask for an itemized bill.

## **Get Free Advice**

Whether or not you get a bank loan to buy your business, your local banker can still be a source of advice and perspective. Loan officers analyze businesses all the time, so they'll evaluate the deal with a dispassionate eye. And the advice is free, because they know you may soon need a line of credit or a checking account.

Go prepared. Have your prospective firm's financials, a three-year pro forma, and a history of the firm. Then let the banker go to work.

## **The Best Opportunities Are Hidden**

Finding a business that fits your skills and personality is not easy. And your job is doubly hard because the great majority of profitable small businesses are never advertised.

That's because highly profitable companies depend on their reputation. What if customers discovered the business were for sale? Maybe they'd get nervous about whether the new owners would deliver good service or raise prices. They might look for another source.

A good company also has excellent employees who fuel its success. If they knew the firm were on the block, they might lose morale, let productivity slip, or look for work elsewhere.

## **The Role of Research**

It's up to you to ferret out the owners willing to sell. By now, you should have an idea of the industry you want to be in, though your skills and desires may lend themselves to more than one. Also, decide now whether you would relocate for the right opportunity.

Then hit the library. You'll research two things. First, you want names of specific companies. Second, you want to understand industry issues and practices that affect any company you might buy.

## **Directories and Trade Magazines**

The reference section in your library will have directories to help you identify specific businesses. These cover much more narrow topics than you think; you'll find books like *Acoustical Contractors*, *Glass Factory Directory*, *Directory of U.S. Meat Suppliers*, and *Lasers and Optronics Buying Guide*.

Your other source of information is trade magazines. These can also be narrow. The car market alone boasts such niche titles as *Automotive Aftermarket News*, *Exhaust News*, and *Modern Tire Dealer*. Search the *Business Periodical Index* for publications in your area.

## **Answer Critical Questions**

Besides names of specific businesses, trade magazines can give you the answers to questions like:

- What are the key industry issues?
- Is the industry growing or dying?
- Who are the innovators in the industry? Why?
- How is technology affecting the business?
- What's the potential over the next five years?
- Can small firms compete?

- How much revenue and profit can a small company generate each year?
- How much capital do you need to compete effectively?
- Am I interested in this industry?
- Do my skills fit this industry?

### **Get a List of Prospects**

Your research will yield a ton of insight plus a list of companies. But you still don't know whether these firms are profitable or if the owner wants to sell. But when you call, you'll be ready. Owners, especially those who've never thought of selling, won't sell to just anyone. They'll prefer someone who knows about the industry and its critical issues.

### **Next: Sound Out the Owner**

With a list of prospects in hand, the action begins. Your best bet is to write a letter first and follow it up with a phone call. Be short and to the point. After an introduction that refers to the company and the industry, say something like: "I'm interested in the possibility of buying your business. I'm financially and professionally qualified to do so; if you'd like to explore the issue, let's talk. I'll call you Friday."

Be sure you have the name and address right, use nice stationery, and write "Personal" on the envelope.

The phone call is critical. If you don't sound professional, you may get an immediate rejection.

Your goal in making the call is to set up an appointment to meet the owner. Again, keep it short and simple. If you get a strong "No," move on.

Often, however, you'll get a weak no. Don't try to discuss things that could be handled best in person, but suggest that a meeting might be fruitful: "I agree that selling wouldn't make sense if it weren't a good deal for you. But it wouldn't hurt to talk, would it?"

Your success rate will be around 15-20 percent, so it might take twenty calls to arrange four meetings.

### **Use a Business Broker?**

While there are excellent brokers out there—those that concentrate on selling consistently profitable businesses—many brokers are all too willing to peddle anything.

Moreover, fewer than 20 percent of all businesses are sold through brokers, even though a majority of buyers use them and classified ads for leads.

That leaves the field open for those willing to dig to locate opportunities.

Yet, a good broker can be helpful. To find one, arrange face-to-face visits and ask about personal business experience. Many have none. Also, ask how many businesses he or she sold in the last year, and in what fields. Last, get references.

And never forget: The broker represents the seller.

### **Begin to Establish Trust and Rapport**

Your goal in the first meeting with a prospective seller is to get enough information to decide whether it's the right opportunity. But that's not all. You also need to begin building trust. Throughout the process, you want to convey to the owner that you're competent and worthy of respect. That's the only way you're going to get good information. After all would you reveal your net profit or marketing strategy to a stranger?

Begin the meeting then by addressing the owner's prime concern—confidentiality. Come armed with a non-disclosure statement like the one below.

### **Start Slow**

Don't charge right into specifics—you might scare off the owner. Instead, summarize your background and tell why you set up a meeting.

Next, turn the focus towards the owner. Ask easy questions: How he got into the business, what his back-ground is, how his experience helped make the business successful, etc.

### **“What Business Are You In?”**

Bridge next to the business itself. A seemingly basic question like, “What business are you in?” can be revealing. It may give you a clue as to whether you can expand it. For example, if the owner says she’s in the “burglar alarm business,” maybe you can come in and position it instead as a provider of corporate security services.

### **Now Get Specific**

As you proceed, hone in on details. If you’ve primed the pump, you’ll get a flood of information. Oftentimes the owner will tell you everything you want to know. Use the questions to the right as a guide, but remember that you’ll have many others.

### **Keep Your Eyes Open**

When you meet with the owner and tour the facility for the first time, you can, as Yogi Berra says, “observe a lot just by looking:” Is the place clean and orderly? Are the employees happy? Are the machinery and equipment in good shape? Does the phone ring often?

### **The Essential Questions**

When you visit a business, try to get answers to these questions. You may not get them all at first, but you’ll need the answers eventually.

- What’s the history of the firm?
- What products and services are offered? Who buys them?
- Is the industry growing?
- What are profits and revenues over the last five years?
- How many employees?
- Which are the key employees?
- How are people paid? Benefits?
- Which are the key vendors?
- Any lawsuits in the last five years? Any still in process?
- Does the business depend on any copyrights, patents, proprietary data bases, customer lists, etc.?
- What’s the inventory’s value? How often does it turn?
- How much in accounts receivable? How much is past due? Amount of payables?
- How valuable are the assets?
- What’s the monthly rent? Is the lease assignable?
- Total number of customers? Which are key?
- What are the sales and marketing strategies? Sales projections?
- Is the owner responsible for a large part of the sales?
- Any distributors for the product? What are the terms?
- Who are key competitors? Do they have advantages? What’s their market share?
- How big is the market?
- What is the company’s advantage? (Image, technology, low-cost provider, topnotch service?)
- Is there potential for developing new markets?
- What are the entry barriers to the market?
- How important is the current owner to the success of the business?
- What’s not included in the sale?

### **Get the Full Picture**

You’ll have a lot of information from your first meeting with a business owner, but you need more. You’ll get it, with the owner’s permission, from different sources.

**Talk to Competitors.** Tell them you’re thinking of buying into the industry (so talk to those in a non competing geographical area), or that you’re doing research. You’ll find some people surprisingly forthcoming with good information.

Ask who the major players are, which companies are the best and why, what’s the best way to keep overhead down, what’s the best selling strategy, etc. Talk to Customers. Customers are your most important asset, so get as much information as possible.

Ask: How long have you been a customer? Why do you do business with the firm? How well does the product or service meet requirements? How much business will you do with the company this year? What must the company do to keep your business? What would cause you to switch suppliers?

Also gauge how much business depends on personal relationships the present owner has developed with customers.

**Talk to Employees.** Before you sign a contract to buy, talk with key employees. Usually the owner won't permit this until the deal is all but consummated.

Your first task is to reassure them that the transition will be smooth. Next, explain how you'll work with people on a day-to-day basis, then find out what they think are the strengths and weaknesses of the company. Do they think it could be run better? How?

Be alert for anything that might change your mind about buying. For example, you may sense that the sales manager is going to insist on a big raise if you want her to stay. Last, identify problem employees as best you can, and get a feel for overall morale.

### **Hide and Seek: Examining Financial Statements**

Studying the financial statements—balance sheet, income statement, and tax returns—is the key element in deciding whether or not to buy a business. Get them for at least the last three years.

### **Call in the Accountant**

Your accountant will spot things you might miss. For example, say you get excited about a high profit business. The accountant looks at the financials and discovers that the owner hasn't replaced inventory for ten months. And that she owns the building and rent expenses for you would triple.

### **Look for These Tip-offs**

Pay attention to a few items the financial statements:

- Using the balance sheet, calculate the quick ratio. Divide the most liquid assets—cash, short term securities, and receivables—by current liabilities. This tells you if the firm has the liquidity to weather a disaster. A one-to-one ratio is acceptable; two-to-one is better.  
“Remember this: Don't ever take the financials at face value. Financial statements in most small businesses are prepared to minimize tax liability.”
- Look carefully at the operating expenses on the income statement. It shows where the major costs in doing business are. Analyze each line item, because any one might hide problems. Maybe the merchandise is shoddy and customers often return shipments.
- What's the net profit margin? Trade associations can give you an industry average; the median for all companies is about 5%.
- Analyze the company's performance going back five years. Look for a pattern of success—consistent profitability, rising revenues, stable expenses.

### **Owner Benefit—Where Profits Lie**

The value of a business lies in its ability to generate profit for an owner. But because many owners try to minimize taxes, they may inflate certain expenses, gain a tangible benefit and narrow the bottom line.

For example, travel expense may be huge because the owner routinely works out of his “office” in Aspen. Or the \$40,000 a year vice president may be the owner's spouse who shows up once a month.

To arrive at a value for the business, you'll have to recreate the income statement to reflect the true profit. Go through the operating expenses line by line and ask, “Is this cost normal?”

If in doubt, ask the owner. She has a stake in showing you how profitable the business really is.

While you're at it, look for places where expenses will rise. For example, rent may be low, but it might go up if you take over.

Also, add non-recurring items back into the profit. An example: the \$15,000 the owner spent to repair the roof. It's unlikely you'll have to do that job again.

If you add the non-recurring/owner benefit items to the stated net profit, and subtract things you'll have to pay more for, you've got a picture of the firm's real profitability—and a figure you can use to value the business.

### **What's the Business Really Worth?**

With a working knowledge of the financial statements in mind, it's time to value the business. Use the following methods for each of the last three years—and have your accountant check your work.

#### **Asset Valuation**

Use this method when the business is asset intensive. Value assets at their current market value, not the replacement or liquidation value.

If a company has a great deal of equipment and other fixed assets (as would a small manufacturer), have assets appraised professionally. (FMV/FA in the formula is the Fair Market Value of Fixed Assets.)

Next, add leasehold improvements (LHI). These are additions, modifications, and upgrades to the physical property. (Improvements should be listed in the financials.)

Then add in owner benefit (OB)—the seller's discretionary cash flow for one year (see page 6)—and inventory (I). The result is the market value (MV) of the business.  $FMV/FA+LHI+OB+I=MV$

#### **Capitalization of Income**

This method places no value on fixed assets, because you assume their only value is to produce income for the business. This method works well for non-asset-intensive businesses like service firms. Your goal is to value the intangible aspects of the business. To begin, rate the following on a scale of zero to five, with five the highest score:

1. The owner's reason for selling. The more urgent the owner is to get out, the lower the score.
2. How long the firm has been in business. The longer the better.
3. How long the current owner has owned the business.
4. Degree of risk. Restaurants and retail stores score low.
5. Profitability. Are there consistent, acceptable profits for five years? Give it a high score.
6. Location. Is the business in the right place to do business? Is there an adequate pool of possible employees? If so, score high.
7. Growth history. Give high marks for consistent growth in the 10-30 percent range.
8. Competition. High marks for few competitors or an advantage.
9. Entry barriers. Low marks if anyone can get into the industry.
10. Future potential for the industry. Low marks for mature industries.
11. Customer base. High marks for diversity, growth, repeat business.
12. Technology. State of the art equipment? Trained personnel? Score high. You've had to do your homework to rate these items accurately. Total the figures and divide by twelve. The result is the Cap Rate. Next, take 75 percent of the owner benefit (OB). This gives you the buyer's discretionary cash (BDC). (You assume the other 25 percent will go toward debt service.) Now multiply the two for a market value.  $Cap\ Rate \times BDC = MV$

#### **The Rule of Two-Thirds**

It's essential that your prospective business can finance the debt from cash flow. The Rule of Two Thirds says: "If the business will not support a debt service of two thirds the purchase price, pass or lower the purchase price." Even if you put down more than a third, the profit should still be able to cover two-thirds.

#### **Owner Benefit Valuation**

This one's easy. Take the owner benefit and multiply it by 2.2727 and you get the market value. (The multiplier is derived by taking into account standard figures for debt service, return on investment, and an allowance for living wage.)  $OB \times 2.2727 = MV$

Don't be surprised if all these formulas result in similar numbers. That's the idea. You want to show a seller that a business has a certain value even when looked at from different angles. The more facts (based on financials) you present, the more seriously your offer will be taken.

### Quick & Dirty: Industry Multipliers

A fourth way to value a business is to use these formulas. Some people swear by them, but they often give a simplistic view of a business's worth. Nonetheless, in some cases they may give you a rough estimate of value.

**Food distributors:** 1 to 1.5 x annual net profit + inventory + equipment

**Insurance agencies:** 1 to 2 x annual renewal commissions

**Job shops:** .5 x annual gross sales + inventory

**Manufacturing:** 1.5 to 2.5 x annual net profit + inventory, or .75 x annual net profit + equipment + inventory

**Newspapers:** .75 to 1.5 x annual gross sales

**Professional practices:** .1 to 5 x annual net profit

**Real estate agencies:** .2 to .3 x annual gross commissions

**Restaurants:** .3 to .5 x annual gross sales, or .4 x monthly gross sales + inventory

**Retail business:** .75 to 1.5 x annual net profit + inventory + equipment

**Travel agencies:** .05 to .1 x annual gross sales

### Make a Strong Offer Based On The Facts

Buying a business is like getting married; you have to satisfy each other's needs. It's not a contest to be won, so aim for a win-win deal.

#### The Letter of Intent

Begin with a letter of intent. Draft it yourself, but have your lawyer look it over.

The letter isn't a formal offer; it's a proposal that covers your view of the key issues in the purchase. In it, you'll propose a price and the financial structure of the deal, and you'll discuss contingencies.

Contingencies are issues such as the assignment of the lease, agreements to keep key employees on the payroll, what's included in the sale, and much more.

Don't try to specify every contingency, and don't spell out the details of those you mention. This gives you room to negotiate. For example, rather than saying, "The seller shall receive an annual consulting fee of \$75,000 for two years," simply say that you'll "arrive at a mutually beneficial consulting arrangement."

#### A Word on Price

Decide exactly how much you're willing to spend to buy the business. Be prepared to walk away from the deal if it goes over that amount. But don't tell the owner—yet—what you're willing to spend. Experienced negotiators suggest first offering 25 percent less than you're willing to pay, 50 percent below what you'll agree to on the interest rate, and half of the money you're willing to put down. This gives you room to maneuver.

#### It's What She Means, Not What She Says

When negotiating, listen closely for the real issue behind a stated position. If the seller says, "I want all cash," the issue may be that she thinks you'll ruin the business and she'll have to take it back. Once you define the root concern, you can find a win-win solution.

#### The Negotiation Strategy

Before you deliver your offer, make a list of every issue that could come up when you meet the owner. Show the list to your advisors for their input.

Have a position on each issue and be prepared to say why. Base arguments on logic, not emotion.

Also, make a list of benefits to the seller. You may need to push hot buttons—the promise of financial security, golden retirement years, peace of mind—at strategic moments.

#### Present the Offer

Deliver your letter of intent in person so you can explain the proposal and gauge the owner's initial reaction. Don't negotiate at this point; just clear up confusing points.

The fun begins with the second meeting. Expect the seller to blow off steam and insult your offer—after all, you're discussing what may be her life's work.

Refuse to argue or fight back. Instead, identify the issues that you agree on and those that require resolution.

### **Attack Problems Together**

Expect to meet with the seller a number of times to discuss the issues. When faced with tough problems, ask, “How can we come to a solution that benefits us both?”

Again, think win-win. Maybe the owner wants \$750,000 for the business. You want to pay \$650,000. The real issue may not be the price—it’s that the seller wants to clear \$500,000 after taxes for a comfortable retirement. Maybe you can offer a long-term consulting contract. Maybe you can agree to his price if he’ll extend payments.

If you’re truly open to a win-win deal, you can negotiate all the difficult points and arrive at a deal that satisfies you both.

### **Negotiating Guidelines**

To keep the negotiation moving along towards an agreement, remember:

1. The stated issue is not always the real issue, and the first offer is never the final offer.
2. Always have the facts to support your case.
3. Cash is king. The more you can offer, the lower the price.
4. Create an agenda and a time limit for each negotiating session.
5. Given taxes, a dollar isn’t always a dollar. Your accountant can help you come up with ways to put more money in the owner’s pocket.
6. The relationship is everything.

### **The Voice of Experience**

Heed the wisdom of those who’ve bought their own businesses:

- “Work hard on developing the right kind of relationship with the seller. In many cases, you need him or her after the sale.”
- “If a deal is going to go, it works largely on the basis of trust.”
- “Figure out what you’ll need to run your company in the first year and double it.”
- When considering buying a business: “Ask what’s the worse thing that can happen? . . . Do you want to spend your life thinking you had a chance to do what you wanted and didn’t take it?”

## **Selling Your Business Ten Steps to Maximize Value**

**By David M. Kauppi, CBI, President Mid Market Capital**

If you are considering selling your business this article will help you evaluate your company as a strategic acquirer might. From that perspective it pays to focus on ten critical areas of value creation. The better your performance in these areas, the greater the selling price of your business. Below is our list of strategic value drivers.

**1. Customer Diversity** – If too much business is concentrated in too few of your customers, it is a negative in the acquisition market. If none of your customers accounts for more than 5% of total sales, that is a real plus. If you find yourself with a customer concentration issue, start focusing on a program to diversify.

**2. Management Depth** – An acquirer will look at the quality of the management staff and employees as a major determinant in acquisition price. You should make the move of assigning your successor a year in advance of your scheduled departure date. If you have a strong management team in place, you should try to implement employment contracts, non-competes, and some form of phantom stock or equity participation plan to keep these stars involved through the transition.

**3. Contractually Recurring Revenue** – All revenue dollars are not created equal. Revenue dollars from a contract for annual maintenance, annual licensing fees, a recurring retainer fee, technology license, etc. are much more powerful value drivers than projected sales revenue, time and materials revenue, or other non-recurring revenue streams.

**4. Proprietary Products/Technology** – This is the area where the valuation rules do not necessarily apply. If strategic acquirers believe that a new technology can be acquired and integrated with their superior distribution channel, they may value your company on a post acquisition performance basis. The marketplace rewards effective innovation and yawns at “me too” commodity type products or services. Continue to look for ways to innovate in all facets of your business. If you create a technology advantage in your company, think what that could mean to a much larger company.

**5. Penetration of Barriers to Entry** – In its simplest form, a large restaurant chain buys a small family owned restaurant to acquire a grand fathered liquor license. Owning hard to get permits, zoning, licenses, or regulatory approvals can be worth a great deal to the right buyer. The government market is extremely difficult to penetrate. If your product or service applies and you can break through the barriers, you become a more attractive acquisition candidate.

**6. Effective Use of Professionals** – Reviewed or audited financials by a reputable CPA firm cast a positive halo on your business while at the same time reduce the buyer’s perception of risk. A good outside attorney reduces the risk even more. A strong professional team is a great asset in growing your business and in helping you obtain maximum value when you exit.

**7. Product / Sales Pipeline** – Smaller companies often are more agile and have better R&D efficiency than their high overhead big brothers. In technology, time to market is critical and big companies evaluate the build versus buy question. Small companies that develop new technology are faced with the decision of developing distribution internally or selling to a larger company with developed channels. A win/win scenario is to sell out at a price, in cash and stock at closing, that rewards the smaller company for what they have today, plus an earn out component tied to product revenues with the new company.

**8. Product Diversity** – A smaller company that has a quality portfolio of products but may lack distribution can become a valuable asset in the hands of the strategic buyer. A narrow product set, however, increases risk and drives down value.

**9. Industry Expertise and Exposure** – Encourage your staff to publish articles and to speak at industry events. Encourage local and industry reporters to use you as the voice of authority for industry issues. Your company is viewed in a more positive light, gets more business referrals, and an industry buyer will remember you favorably as an acquisition candidate.

**10. Written Growth Plan** – Capture the opportunities available to your company in a two to five page written growth plan. What additional markets could we pursue? What additional products could we deliver to our same customers? What segments of our current market offer the most growth potential? Where are the best margins in our customer base and product set? Can we expand in those areas? Can we repurpose our products for different markets? Can we license our intellectual property? What about strategic alliances or cross marketing agreements? Documenting these opportunities can add to the purchase price.

When it comes to unlocking the market value of your privately held company, it is not limited to the bottom line. Profitability is hugely important, but the factors above can result in significant premiums over traditional valuation approaches. When you sell Microsoft stock, there is no room for interpretation about the market price. The market for privately held businesses is imprecise and illiquid. There is plenty of room for interpretation and the result for the best interpretation by the marketplace is a big pay off when you decide to sell.

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## EVALUATION GUIDELINES FOR BUYING A SMALL BUSINESS

One of the most often questions asked about buying a business is how much should someone pay for the business. While there are many factors that go into this decision, there are some guidelines that will help the buyer in determining whether to proceed or not. The purpose of Sections 1 and 2 are to bring to your attention all the things you should consider.

### 1) Ask yourself:

#### a) What do I know about the business you're buying or industry your going into?

#### b) What is my experience in:

- \* Management
- \* Operations
- \* Sales & marketing
- \* Finances and record keeping

#### c) Do I understand the meaning of the following terms?

- |                       |                             |                      |
|-----------------------|-----------------------------|----------------------|
| * Gross Margin        | * Gross Profit & Net Profit | * Break-even point   |
| * Turnover            | * P & L Statement           | * Cash-flow Analysis |
| * Accounts Receivable | * Accounts Payable          | * Terms of Credit    |

If I do not know the meaning of these terms, where do I get the information?

#### d) What do I know of the industry:

- \* The competition and their location
- \* Where my potential customers or market is

#### e) What do I know about the business I'm buying:

- \* Track record of the business – sales, expenses, profit for the past 3 years.
  - \* If decreasing, why?
- \* Do they have a lease:
  - \* What are the terms of the lease in time and cost?
  - \* Do you assume the current owner's lease or do will you have to sign a new one?
- \* Are you buying real property as part of the sale? Is it part of the same transaction or will it be separate from the purchase of the business?
- \* What is the reason the business is up for sale?
- \* What are they asking for the inventory and/or equipment and what is it really worth.
- \* What is the potential for improvement
- \* What agreements, if any, are in place with suppliers and customers?

#### f) Where are the sources of money for:

- \* Buying the business
- \* Sustaining the business
- \* Expanding your business

#### g) Would I be better off putting the money in the bank?

**h) Have I received the last 3 years financial records and tax information from the seller?**

**i) Inventory:**

**\* Equipment**

\* What is the age and value of any equipment and is it valued at cost, depreciated cost, replacement or salvage value?

\* What is it worth to me?

\* Who did the evaluation or does it need to be evaluated by an independent appraiser?

**\* Products to use/sell**

\* What is the age and value of finished or unfinished parts or other inventory and is it at cost, replacement cost, selling price, or close-out value?

\* What is it worth to me?

\* Who did the evaluation or does it need to be evaluated by an independent appraiser?

**2) Is the business dependent on the personality of the current owner(s)?**

**a) Will the current owner(s) stay on as consultants or still be active in the business?**

\* For how long a time?

\* If the current owner(s) leave, will this deter you from making the changes you see as a way to increase sales?

\* Will their leaving the business have a negative effect on sales?

**b) The staff**

\* Who are the key people that are vital to the continued success of the business?

\* Will they stay on, and/or do you want them to stay on?

**c) How much training will the current owner provide?**

**d) Will the current owners help with a smooth transition with customers and suppliers?**

**3) Evaluation formula for business acquisition. Rate each category from 0 to 6 (6 = top rating) SCORE**

**a) Risk** – Continuity of income at risk/Steady income likely/Growing income assured \_\_\_\_\_

**b) Competitive** – Highly competitive conditions/Normal competitive conditions/Little competitive conditions \_\_\_\_\_

**c) Industry** – Declining Industry/Industry growing faster than inflation/Dynamic Industry – rapid growth likely \_\_\_\_\_

**d) Company** – Not well established/ Well established with satisfactory environment/ Long Record - well established reputation \_\_\_\_\_

**e) Company** – Business has been declining or steady growth slightly faster than inflation/ Dynamic growth rate \_\_\_\_\_

**f) Desirability** – No status – rough or dirty work/Respected business in satisfactory environment/Challenging business – attractive environment \_\_\_\_\_

**g) Total Score** \_\_\_\_\_

**h) Valuation Rating Factor** (divide Total Score by 6 =) \_\_\_\_\_

**4) Determining the average annual income of the business**

<b>a) Basic Valuation</b>	Current Year	Last Year	Previous Year
Net Income	\$ _____	\$ _____	\$ _____
+ Adjustment (Owner's salary + entertainment + anything that looks like the owner used for him/herself)	\$ _____	\$ _____	\$ _____
<b>b) Weighted Amount</b> (Benefit accrued to the owner)	\$ _____ (b-1)	\$ _____ (b-2)	\$ _____ (b-3)

<b>c) Weighted Averages</b>	Amount	Weight	Weight Amount
Current Year (b-1)	\$ _____	x 3	\$ _____
Last Year (b-2)	\$ _____	x 2	\$ _____
Previous Year (b-3)	\$ _____	x 1	\$ _____

**d) Total Weighted Amount** \$ \_\_\_\_\_

**5) Average annual income value** *(Total Weighted Amount divided by 6)* \$ \_\_\_\_\_

**6) Valuation of the business**

<b>a) Income Value multiplied by the Valuation Rating Factor</b> <i>(See 3h)</i>	\$ _____
+ Accounts receivable	\$ _____
+ Fixed Assets	\$ _____
+ Cash, – accounts payable.	\$ _____

**b) VALUE OF THE COMPANY** \$ \_\_\_\_\_

**7) Years to recover investment** \_\_\_\_\_  
*(determined by dividing Value of the Company - 5b  
 by Current year's average annual Income – 4a-1)*

Note, A general optimistic guideline is 5 years or 20%/year).

This form for estimating the value of a small business is only one of many different formats used in business and industry. It may be that the business you are interested will call for a different format. In that case, we suggest you contact a business broker or a CPA who does this type of work.

## BUYING A BUSINESS WHEN STORM CLOUDS ARE ON THE HORIZON

By Cliff Ennico

“My wife and I are looking to buy a small business. We were looking for a very specific type of business, but we’re a little nervous because there’s a good chance the business model will be affected by the new federal health care law. We’ve found a fairly healthy business in our area. The seller is willing to sell, and acknowledges our concern about the new law, but insists that the purchase price be based on his annual gross sales for the past year. While that would be fair in a normal environment, we’re concerned that sales for the next couple of years will be significantly lower because of the regulatory changes the new health care law will require.

No one can predict the future, and we don’t want to deny this seller the opportunity to get a return on the last 10 years he has spend building this business. But we don’t want to buy at the ‘top of the market’ if this business model is destined to collapse in the near future.”

Normally, the purchase price of a business is based on the business’ past performance – usually it’s a multiple of the seller’s average gross sales or pretax earnings over a number of years. The first thing you should do is look at this seller’s gross sales over the last 5 years (the recession years of 2008 and 2009 probably distorted his results so you need to look back over a longer period). Do a quick arithmetic average of his gross sales over the five year period. If the average is significantly lower than his gross sales last year, then the purchase price he is asking for is not reasonable, regulatory change or not.

Assuming his quoted purchase price is reasonable, you will need to factor in the risk of regulatory change going forward. It will be almost impossible to quantify that risk, so the best you can do is to make the seller share that risk with you. Under no circumstances should you pay for this business “all cash”. You should insist that the seller accept at least 25% to 30% of the purchase price in monthly installments over the next two to three years with interest at a commercial rate (currently about 5% to 6% per annum).

If the seller is agreeable to that, then you need to limit your downside risk. The most common way to do that is to put on a “ratchet clause” in the contract of sale allowing you to reduce the portion of the purchase price you are paying over time in the event regulatory change – or indeed any change that is beyond your control (such as the recent spike in oil prices) – reduces your gross sales or squeezes your profits.

First, you figure out what the seller’s average gross sales were for the past two to three years. Then, you and the seller would agree that if your average gross sales falls below 90% of that monthly average for a period of three consecutive “rolling” months due to circumstances “beyond your reasonable control”, you can reduce the balance due to the seller dollar for dollar by the amount of the shortfall each month for as long as the situation continues. You are still stuck with a potentially losing business, but the seller is sharing the pain with you by seeing the outstanding portion of his purchase price get lower and lower each month.

What happens, though, if the business suffers a revenue loss due to your own incompetence in running the business? Reducing the purchase price dollar for dollar in that situation allows you to profit from your own lack of business skills, which the seller won’t tolerate.

As Shakespeare would say, “ay, there’s the rub.” Your attorney will need to draft the ratchet clause very carefully, and provide for informal but binding third party mediation if there’s a dispute down the road over whether the business downturn is your fault or the Government’s.

Another, but less common, way to protect yourself against future risk is to insist that the seller “guarantee” your monthly revenue for a period of time after the business changes hands (usually one year). You would hold back a portion of the purchase price (10% to 20% is customary) and deposit it in a no-interest escrow account. Then, if your actual monthly gross sales during the next year fall below the agreed-upon threshold, you simply withdraw the shortfall amount from the escrow deposit. At the end of the one-year period the seller gets whatever is left in the account.

The seller won’t be wild about either of these options, but if he has a brain in his head he probably recognizes the regulatory risk and will accept the fact that it may be a lot harder to sell this business two or three years from now – when the full impact of the health care law changes are known – than it is today.

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